Audit's NEWS ANALYSIS OF SECURITIES OF REAL ESTATE INVESTMENT TRUSTS

Realty Trust Review

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VALUE GUIDE TO TRUSTS REVIEWED THIS ISSUE

Trust	Rel. Appeal	Port. Yield	-12Mo.Port.Chng.- Last	E.Next	Lever. Ratio	Price	Ann. Yield*	Div. Reinv.	Page
Conn.Gen. M&R	2	11.29%	4%	0%	1.26	$13.88	11.5%	No	5
Equitable Lf.Mtg.	2	11.06	26	11	1.52	17.25	11.6	Yes	6
AVERAGE		11.18%	14%	5.5%	1.39		11.6%		

*Based on annualized latest qtr.

REIT BONDS: A VERY MIXED BAG RUNNING A WIDE GAMUT OF SPECULATION

Speculation in trust debt has become more widespread lately, partly in keeping with growing interest in debt issues generally including convertibles, and partly because of deep discounts on REIT debt. We pointed out in our July 29 RTR issue last year that convertible debentures offered attractive appreciation and yield characteristics when selling at deep discounts. We focused on some of the better quality converts which since changed little in price although they are slightly lower on balance. This is about as good as the general market but better than trust shares on average. Additionally, interest payments continued, producing good yields in the interim.

Our view of converts remains unchanged. They offer some protection of yield compared to shares and, when priced near parity with the shares, offer almost equivalent upside potential as the shares. The debt play has widened considerably in recent weeks to include straight trust debt and possibilities may even cover some very low grade junior debt at that. We mentioned this last issue in context of banks holding senior debt protecting their position by allowing junior debt to stay current. (Default to a junior creditor could throw the whole package into bankruptcy.)

This latter group of trust debt, the deep discount paper contingent on complex arrangements with all classes of a trust's debt, is becoming very tangled by restructuring agreements. And beyond the immediate approval of changes required from all classes of creditors, further muddying of the waters is possible from potential lawsuits by a minority of creditors or even shareholders.

Your strategy in speculating in trust debt starts with recognizing there are <u>two broad group of REITs</u>: the <u>relatively better quality and stronger trusts</u> that have maintained most shareholder earning power and <u>weaker trusts</u>, generally

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not paying dividends with their survival in doubt as going entities. Both groups have many debt issues out.

1. Debt of better quality trusts is still not investment grade, A rated or better. Take one of the best trust junior instruments, *First Union Real Estate* convertibles. Last year's coverage of these debentures and the preceding short-term interest was 1.9 times including available net cash flow from depreciation. Moreover, this does not consider coverage of mortgage interest. This complexity is the major reason why real estate debt is not rated by the bond rating agencies. Thus at best you're playing with B grade debt, probably lower B at that.

Today you will pay about 50-70¢ on the dollar for this grade debt. There is not much margin for error but barring general economic collapse and impairment of real estate values, these trusts should not only maintain interest but also most of their dividends. We would consider our higher ranked trusts, 2 and 3 in monthly Relative Appeal Rankings, suitable issuers. Many happen to be equity and long-term oriented, the latter including the big five life insurance sponsored REITs. Current yields run about 10%, not exceptional for these money markets, with yield to maturity running a little higher for holders waiting redemption, about 15 years. For these convertibles, eventual possible appreciation in their corresponding share prices would provide modest capital gains.

2. The big play in high-yielding junk debt may be ending because banks may not continue funding junior interest payments. This trust debt is available for perhaps 10¢-25¢ on the dollar and speculators are looking for anything from a few interest payments to provide a return of capital plus good yield even if principal gets washed out. Upside may even provide for long term workout at par, your proverbial dollar. This area is a minefield for speculators. The first booby trap is the hope that senior creditors (banks) want to pay current interest on the junior debt. This becomes less likely. Bank strategy is to keep trusts afloat to fund projects to completion which should be accomplished by the end of 1976. Repayment to the trusts and then to the banks should then take place. The banks would then be out of their senior lending to trusts by say 1977.

Banks appear less and less willing to pay interest on convertibles and other junior debt as time goes on. As part of its revolving credit reached last week with banks led by Continental Illinois Natl. of Chicago, NJB Prime Investors must ask holders of its 7% subordinated debentures due 1980 and 6-3/4% subordinated convertible debentures due 1991 to defer interest payments scheduled this fall and next spring until Sept. 30 & Nov. 1, 1976, respectively. Interest payments due March 31 and due May 1 on these issues were and will be made, however. In addition, Dominion Mortgage announced tentative agreement on a new revolver and cautioned that debenture interest might not be paid this fall, even though the loan agreement provided for payment. Non-bank senior debt, however, has not been requested to defer.

All this means that banks are taking a stiffer new line on paying interest on subordinate debt. How far this will go is not clear at all. But the clear signal is that speculators seeking high yields may find themselves asked to defer interest.

3. Pledging of REIT assets to their bank lenders is growing. Last August, National Mortgage was required to pledge virtually all its mortgages to the banks and earlier this month, NJB Prime Investors announced it agreed to give its banks a secured position on 67% of its assets. While preferential treatment was certainly given the senior creditor banks, the trusts involved claim equity was received and agreement justified by economic reality. NJB for example was able to fund interest due junior debentures in April and May and will be able to fund commitments. The alternative of bankruptcy has drawbacks. If commitments could not be funded, claims would have arisen from developers, particularly with incomplete projects. If the trust had filed Chapter XI, the SEC might have pushed them into costlier Chapter X since NJB has $29M public debt (or one-third of total capital).

Ultimate judgement is hard to make. Much depends on what assumptions are used as to workout possibilities over different time frames (the trust bought time which is to the good) and what alternative costs would be staying viable vs. operating out of bankruptcy. Other justifications for granting banks secured positions were that as senior creditors they would have had prior position in bankruptcy anyway and the banks gave consideration in lowering interest rate from 130% of prime to prime. However, the subordinated debt is being asked to defer second half 1975 interest. Equity to all parties may be secondary to push and shove in negotiations but implication is clear for junior debt and shareholders. Their position in forthcoming arrangements is weaker with regard to the REITs' mortgage hold on loans.

4. Near-term maturities of debt are a caution signal for potential bankruptcies. Things may roll along while junior interest is being paid which the banks may well fund in order to get themselves out. When this debt comes due, it may be a different story. Continuing our analysis of bank strategy, they hope to be out of most their REIT loans by the time this junior debt, much in the form of seven-year non-convertible debentures, come due in 1978-79. Remember, it was a debenture coming due in Dec. 1973 that did in Associated Mortgage causing it to file Chapter XI three months later. The crucial aspect of maturing debt will in many cases be whether it is privately or publicly held. Private holders being one or a small group are likely to remain accommodating as the banks and extend their loans. The indenture trustee, however, of a publicly held debenture has a fiduciary obligation and is not as flexible. At best, permission will have to be obtained from the holders to permit extension. While it goes against the grain of bankers to fund repayment of creditors junior to them, conditions of hard realization may force some concessions to bail out REITs on this score. Witness concessions granted by senior creditors in First Mortgage's case outlined on the next page.

Given potential importance of debt maturities, we have summarized some of the more significant loans coming due the next four years. Trusts and amounts are shown by year. (Mil.)

1975		1976		1977		1978	
Amer. Cent.	$20	Bldr.Inv.Gp.	$16	First Mtg.	$25	Benef.Std.	$15
Bldr. Inv.Gp.	16	Cit. & Sou.	15	Gulf Mtg.	20	Chase Man.	50
First Mtg.	16	State Mut.	15	Mtg. In. Wash.	10	Diversif.Mtg.	30
				State Mutual	27	Natl. Mtg.	5
				U.S. Bancorp	10	Saul, BF	25

This total picture leaves speculators incurring high risk/reward ratios in lower grades, prices notwithstanding. Therefore only speculate in trust debt where the trust has strong workout capability and whose projects are not in deep trouble. That is, beyond two years there should be enough left to support junior debt. In our Relative Rankings, most of our starred 4 and 5 ranked selections should meet these requirements.

REVOLVING CREDITS: FMI'S MAJOR NEW RESTRUCTURING GIVES SHAREHOLDERS A BREAK -- AT LAST

First Mortgage Investor's major restructuring of debt, finally announced after weeks of negotiations, likely will become a trend-setter. The restructuring in effect puts FMI, the oldest construction lending REIT, through privately negotiated bankruptcy without delay and expense of a court proceeding. The "preliminary understanding" also eases the threat of other REIT bankruptcies. The deal converts $70 million of debt into a new preferred stock and still gives existing shareholders a continuing equity ownership in the deeply troubled trust. Terms of the complex deal, which requires many approvals including that of shareholders, boil down in this fashion:

1. Lenders under its $400 million revolving credit (RTR, Feb. 10) agreed to cut the interest, effective Feb. 1, to the greater of a) 1% or b) 100% of income from operations up to the Federal Reserve discount rate, now 6¼%. Any interest paid below the discount rate will accumulate for 11 years, when it would be forgiven April 30, 1986.

The lenders also agreed to accept $25 million of 4% non-voting preferred stock for interest accrued between Sept. 1, 1974 and Jan. 31, 1975. The preferred dividend would be cumulative for two years and the stock would be convertible into shares at $7.

2. All banks holding $5 million or less of loans to the trust can apply to buy land or property from the trust equal to their loan. If the property acquired is in deep trouble, banks will be asked to accept dollar for dollar swaps; if the property is good, the ratio may run up to $3 of property value for each $1 of loan traded off. In this way FMI expects to shed up to $100 million in debt over the next year and raise new cash.

3. Holders of $50 million of private subordinate notes, mainly insurance companies, will take $5 million in cash now and convert $45 million into non-dividend, non-voting preferred subordinate to the bank preferred. This eliminates all interest expense on the $50 million debt. The preferred is convertible at $10 per share.

4. The whole deal hangs upon some forbearance by holders of FMI's 9% senior notes, a $16 million issue sold in 1970. Holders of these notes now have the option of seeking principal repayment between May 1 and Aug. 1 of this year instead of holding to maturity on November 1, 1978. The banks will be able to demand payment on their $400 million revolver unless a "substantial portion" of the $16 million notes waive repayment this year and wait until 1978. These notes had been trading at about 70 on the NYSE, where they offered about 43% capital gain for just over 6 months holding. Interest on all other publicly held debt will continue to be paid if the 9% noteholders go along.

Simultaneously FMI reported the biggest one-year bath in red ink for any REIT ever: $118 million, or $13.89 per share. Of this $28 million was operating loss and $90 million provision for loan losses, including $40½ million for recreational and resort property and the balance based on specific loan analysis. The loss would have thrown FMI into a negative net worth position of about $7 million; the $70 million conversion of debt into preferred equity gives the company some book value. Best of all, current shareholders will wind up with about 51% of the 16.56 million shares, assuming full conversion. Banks would hold 21% and the life insurance companies 27%.

The FMI deal is expected to pace restructuring deals that are becoming the dominant theme for 1975. If 1974 was the year of revolvers, 1975 is shaping up as the year of modification. Great American Mortgage's soliciting of its four debenture holders to approve changing their indentures may be another sign of what's coming. As mentioned Mar. 10, holders of the $273M revolving credit will reduce interest to prime from 130% of prime and accept up to half payment in notes. The public debenture holders are asked to approve changes to eliminate technical defaults by changing requirements for equity (redefined), debt base, debt limitations, debt ratios and disqualify as a real estate trust. All four indenture holders must approve by two-thirds of each class. The Eurodollar senior lenders and term loan lenders have indicated their approval of the proposals.

A sidelight is the accounting profession considering changing the basis of property carrying costs which could go into effect this fiscal year, July 1975, for GAMI. Estimated future carrying costs (losses) would be charged to the current year instead of future years. This could substantially reduce GAMI's equity and if estimated borrowing costs are high enough, eliminate equity, accordingly GAMI and lenders agree to overlook any defaults caused by this accounting change.

A smaller trust, Dominion Mtg. & Realty, came up with a deal remarkably similar to FMI. Dominion would pay 6% during the life of a $19.9 million revolver, if Dominion had earnings sufficient to pay; in no case would Dominion pay less than 2%. All interest, including $525,000 past due, would be deferred to the end of the agreement, in one year. Dominion will collateralize the loan with about 19% of its current loan portfolio.

LONG-TERM TRUSTS: SOME STILL MAINTAINING GOOD RESULTS

The top long term trusts, not coincidentally sponsored by life insurance companies with long, successful real estate experience, continue to provide exceptional performance, given current new construction conditions. Two of these prime trusts are reviewed below.

CONNECTICUT GENERAL MORTGAGE AND REALTY INVESTMENTS (13-7/8--NYSE-CGM) FY Mar.31

Quar.	Port.	Port.Yld.	Non-earn.Inv.	Cash Flow	Div.	-Price range-	-Yld.range-
3/74	$431.6M	10.65%	0.0%	$0.47	$0.44	$20.25-16.38	10.7- 8.7%
6/74	452.7	10.73	0.0	0.47	0.45	18.38-13.50	13.3- 9.8
9/74	429.5	11.16	0.8	0.41	0.45	15.00- 8.50	21.2-12.0
12/74	413.1	11.29	2.9	0.40	0.40	15.88- 9.63	16.6-10.1

Portfolio dynamics: During the past year the portfolio grew a modest 4% and management indicates that investments at year end, March 31 had little change. No new commitments are being made and little growth is expected during fiscal 1976. Composition by type is 46% long-term, 15% construction, 14% other short-

term, 11% real estate owned, 8% land development, 4% land leased to others and 2% partnerships. Though widely distributed geographically, investments have some concentration in the Pacific-Hawaii area and the Southeast. By project type, long-term investments are 56% retail, 31% residential, 11% office building and 2% industrial and other. Real estate owned is 41% residential, 34% retail and 25% industrial & other. Land leased to others is 42% retail and 40% residential with the remainder in office and industrial while partnership is predominantly residential. Some 45% of short-term loans float with market rates so that 17% of total investments are tied to these rates. At Dec. 31, 1974 Conn Gen was not accruing interest on investments totalling $12 million or 2.9% of portfolio. The trust is presently in audit and some increase in non-accruals may result. Involved in the non-accruals are three long-term loans for $4.9M on the following type properties retail, hotel and apartment. Two land development loans for $2.8 million are non-accruing and two loans for $4.35 million are in foreclosure. The loans being foreclosed involve a $3.5 million land development loan in the Midwest and a $850T standing loan secured by two new industrial buildings. At Dec. 31, another 3% of the portfolio was on a watch list but interest accrual was not ceased.

Financing: Conn Gen is funded 44% by capital and 56% by non-convertible debt. The $189.3 million in capital is 59% equity with 5.7M shares and 41% in two (6-3/4% & 6%) convt. subor. deben. Debt of $238.4 million is 35% in short-term bank loans, 32% in long-term bank loans, 24% commercial paper and 9% secured mtg. on real estate owned. In Nov. 1974 the trust went back into the commercial paper market after being out since June. The paper carries a P-1 rating from Moody's and an F-1 rating from Fitch. Bank lines total $169 million. Sponsor: Connecticut General Life Insurance Co., one of the ten largest life cos. The trust works with a 30-member staff of the life co. to produce, fund, service and monitor loans. Results & outlook: The decrease in earnings and dividends for the Dec. qtr. was caused by lower gross revenues, a larger addition to the loss reserve ($375T or $.065 per share) and the significant increase in non-accruals. A dividend of $0.40 per share was recently declared for the Mar. qtr. indicating earnings were fairly stable. However, as mentioned before non-accruals may rise due to the year end audit now in process. The soundness of the portfolio on the whole plus lower interest costs points to some earning recovery. Shares carry a "2" ranking based on the good long-term growth possibilities. The shares remain reasonable purchases for income and probable modest growth. (VCK)

THE EQUITABLE LIFE MORTGAGE AND REALTY INVESTORS (17¼--NYSE-EQ) FY Oct.31

Quar.	Port.	Port.Yld.	Non-earn.Inv.	EPS Prim.	Div.	-Price range-	-Yld.range-
4/74	$314.3M	10.53%	0.3%	$0.53	$0.50	$22.63-18.25	11.0- 8.8%
7/74	334.8	11.61	0.0	0.48	0.50	21.50-13.75	14.6- 9.3
10/74	338.3	11.59	1.1	0.42	0.40	16.00-10.13	15.8-10.0
1/75	355.7	11.06	2.7	0.44	0.40*	15.25-10.00	16.9-11.1

*Excl. $.09 extra.

Portfolio dynamics: In the last year, Equitable increased its portfolio 26% mostly in short-term investments. The trustees recently decided to start making new commitments, generally in construction and other short term loans. Present commitments are $152 million and management estimates that about $15 million per month will be added to commitments. There will be portfolio growth this year with a goal of $400 million to be reached by Nov. 1975, an 11% gain from January. Investments at Jan. were 46% long-term, 29% construction, 20% land & land devel., 3% real estate owned and 2% other short-term. Geographically locations are in 36 states and Wash. D.C. Long-term loans by type were 33%

shopping centers, 14% each apts. and office buildings, 12% hotels and 9% each department stores, industrial and other. Construction loans by type were 22% shopping centers, 26% apartments, 18% each office buildings and hospitals, 13% condominiums and 1% each hotels, department stores and other. At March 31, 1975 some 36% of investments floated with market rates. At Jan. 31, 1975 trust had five non-accruing loans totaling $9.4 million or 2.7% of investments. They were a $847T construction loan on an apartment, a $2.66M land development loan, a $940 land loan and $4.99M in two long-term loans on completed projects with foreclosure proceedings commencing. As of Mar. 31, five loans for $3.7 million were added to non-accruals bringing the total to $13.1 million or 3.8% of investments. The new additions include one constr. loan and one land development loan both to the same company. Cost overruns are responsible. The other three are land development loans to the same borrower who is experiencing financial difficulties.

Financing: Equitable is funded 60% by non-convertible debt and 40% by capital. The $141.3M in capital is 95% in equity (5.6M shares) and 5% in 6-3/4% convt. subor. deben. Debt of $214.3M, all of which floats with market rates, is 44% term notes, 41% commercial paper, 9% demand notes and 6% master notes. During the past few months, Equitable has increased commercial paper (rated P-1 by Moody's) rather than using more expensive bank lines. Although the trust has $161M in lines with 12 banks, only about $5.5 million was being used at Mar. 31. Sponsor: The Equitable Life Assurance Society, third largest U.S. life company. The Adviser maintains offices in 34 U.S. cities. Results & outlook: Although gross revenues were down slightly in the Jan. qtr., lower interest costs produced improved earnings. Equitable just announced a $0.50/sh. dividend for the Apr. qtr. indicating further improvement. Non-accruals increased in the past six months but management has the capability of successfully working out the problems. Strength of sponsor is a big plus. Trust's ranking is "2" remains intact. The share are still reasonably attractive to purchase for yield and probable modest growth. (VCK)

SUBSCRIBERS ASK: IS MY HOPE ANY GOOD? WHAT ABOUT ADVISORY FEES AND REVOLVING CREDITS?

Subscribers have been peppering us with questions about prospects for their particular REIT holdings. Nearly all seek specific buy-sell-hold advice on individual securities they now hold or contemplate holding. We are providing brief written answers to as many as possible below and will continue to do so as space permits. On a much more personal basis, we are pleased to announce that Audit and REALTY TRUST REVIEW will sponsor a one-day seminar titled REITS - WHAT'S AHEAD to provide in-person answers to all the questions you can bring. One will be June 6 at the Waldorf-Astoria in New York and the other June 20 at the Regency Hyatt in San Francisco. We've lined up several outside experts on accounting, bank lending, bankruptcy law and real estate markets to bring their viewpoints to you. Further details and registration information will be sent to you shortly. Some of your current questions:

Q. I am a big investor in *First Virginia Mtg. & REIT*. When I purchased the bonds I thought it was an affiliate of First Virginia Bank because of duplication of many trustees and officers. But the groups are declared independent of each other. Last year with a dividend moratorium in effect the advisers were paid an exorbitant fee. Do you know of any situations of this type involved in litigation? Do you have any information on First Virginia Mtg. & REIT?

A. A number of REITs have been involved in shareholder litigation contesting

the level of advisory fees, perhaps 25-30 trusts so far. Very few cases have gone to final settlement but of those that have, only very moderate reductions in fees have been made. The general pattern has been for negotiated settlements rather than full trial and court decisions. Since advisers are not required to disclose their profits, there is no way to know if any fee is "exorbitant". In the days of soaring REIT earnings, we know from fragmentary disclosures that advisers could earn very high profit margins, up to 60% to 80% pretax profit for some large REITs. Nearly all advisory contracts contain limits on fees that effectively bring advisory fees down to zero when trust earnings decline or the trust loses money. Since mid-1974 this has resulted in about 20 REITs changing fees so that only the adviser's direct expenses are paid (i.e., the adviser earns nothing for its work). Large trusts doing this include Barnett Mortgage Trust, Citizens & Southern Realty, First of Denver Mtg., LMI Investors, etc. Several trusts have moved to let advisory contracts expire with the trust hiring most advisory personnel directly. These have included Mission Investments (formerly Palomar Mtg.), UMET Trust, Builders Investment Group (pending), Pacific Southern Mtg., and Gulf South Mtg.

We feel it is vital for a trust to protect its assets because real estate can deteriorate rapidly from vandalism, weathering, etc. This implies that shareholders must expect on-going operating costs regardless of whether the trust is earning money, and regardless of who is to blame for past mistakes and current problems. Today's changed environment makes milking of trusts through "exorbitant" fees pretty much out of the question, though.

First Virginia Mtg. REIT has announced intent to seek shareholder approval, no date set, for operating as a non-qualified trust so it would not have to pay 90% of earnings in dividends to shareholders, and have greater freedom in managing acquired distress properties. It is thus experiencing the general woes resulting from the current real estate depression, past speculative over-building and economic recession. No rapid recovery is expected.

Q. Would you advise selling *U.S. Realty* and *Flatley Realty* for tax-loss purposes?

A. Recent difficulties with mortgage loans forced UTY into a $39.4 million revolving credit agreement with its bank lenders. A former officer was involved with a Dallas real estate operation, Hill Prop., which went bankrupt, although the trust was not involved. Despite these problems the trust appears to have very sound underlying real estate equity values stemming from properties held for many years, which account for about 50% of investments. Management is seasoned in real estate ownership and we expect it will be able to cope with mortgage loan problems, although that will take time. The dividend likely will not be restored this year and afterward only when real estate market conditions improve. You might switch out of the stock into UTY's 5-3/4% convertibles to provide about 13% yield with reasonable certainty of coverage from real estate cash flow.

Flatley Realty is a smaller trust with about half its investments in apartment ownership and half in mortgages. Its initial offering in May 1972 meant that it was investing offering proceeds into a declining real estate market. The 19% non-earning investment ratio reflects impact of that unfavorable climate. Both Flatley and U.S. Realty shares are starred in our monthly Relative Appeal Rankings, indicating we believe that book value as stated is reasonably sound, largely because of real estate ownership positions. They currently sell about 69% and 55% below depreciated book value per share (with older UTY having far larger depreciation reserves than Flatley).